



## MINUTES

### **Special Meeting of the Investment Committee of the Board of Trustees of the State Universities Retirement System**

**Thursday, November 9, 2017, 9:00 a.m.  
Northern Trust – Global Conference Center  
50 S. LaSalle St., Chicago, IL**

The following trustees were present: Mr. Mark Cozzi, Chair; Mr. Tom Cross, Mr. Dennis Cullen, Dr. John Engstrom, Mr. Paul R. T. Johnson Jr., Mr. Craig McCrohon, Dr. Steven Rock, Mr. Antonio Vasquez and Dr. Fred Giertz via conference call.

Others present: Mr. Martin Noven, Executive Director; Mr. Doug Wesley, Chief Investment Officer; Ms. Kim Pollitt, Senior Investment Officer; Mr. Alex Ramos, Investment Officer; Ms. Kelly Valle, Investment Analyst; Mr. Kevin Leonard, Ms. Kristen Finney-Cook, and Mr. Neil Sheth of NEPC; Ms. Mary Pat Burns of Burke, Burns & Pinelli; Kassandra Hernandez of Fin Daily News; and Ms. Kelly Carson, Executive Assistant, via conference call.

Investment Committee roll call attendance was taken. Trustee Cozzi, present, Trustee Cross, present; Trustee Cullen, present; Trustee Giertz, present via conference call; Trustee Johnson, present; Trustee McCrohon, present; and Trustee Rock, present.

Trustee Antonio Vasquez physically joined the meeting at 9:30 a.m.

Trustee Mark Cozzi made the following motion:

- That trustees be allowed to participate via conference call for the Investment Committee Meeting on November 9, 2017, pursuant to Section 7(c) of the Open Meetings Act.

Trustee Paul R.T. Johnson seconded and the motion carried with all trustees present voting in favor.

Trustee Craig McCrohon physically left the meeting at 12:45 p.m.

NEPC discussed the background of SURS current hedge fund program, reviewed the portfolio, and provided their views of the industry with the Investment Committee. Discussion followed.

The presentation from NEPC titled “SURS Final HF Presentation” is incorporated as part of these minutes as [Exhibit 1](#).

**CLOSED SESSION**

Trustee Cozzi moved that the Investment Committee go into closed session pursuant to §2(c)(7) of the Open Meetings Act to consider the sale or purchase of securities or investments or to consider an investment contract. Trustee Johnson seconded and the motion carried in a roll call vote:

Trustee Cozzi	-	aye
Trustee Cross	-	aye
Trustee Cullen	-	aye
Trustee Giertz	-	aye
Trustee Johnson	-	aye
Trustee McCrohon	-	aye
Trustee Rock	-	aye

**RETURN TO OPEN SESSION**

Upon motion by Trustee Cozzi that was seconded by Trustee Johnson and carried, the Investment Committee resumed the meeting in open session.

There was no further business brought before the committee and Trustee Cozzi moved that the meeting be adjourned. The motion was seconded by Trustee Dennis Cullen and carried with all trustees present voting in favor.

Respectfully submitted,



Mr. Martin Noven  
Secretary, Board of Trustees

MMN/kc



NEPC, LLC

YOU DEMAND MORE. So do we.<sup>SM</sup>



## State Universities Retirement System of Illinois (IL SURS)

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### Hedge Fund Discussion

November 9, 2017

Neil Sheth, Partner

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- **Background of Current Program**
- **Portfolio**
- **NEPC Views of Hedge Fund Industry**
- **Conclusion**

# Background of Current Program

- **Concern(s) Trying to Address:**

- Given low funded level of the Plan, another significant equity drawdown shock may permanently harm the Plan
- Need to alter (lower) potential risk level of Policy portfolio
- Desire to maintain as much return generating characteristics of Portfolio as possible while lowering equity risk

- **Current portfolio has broad exposure to both traditional, public-markets and alternative assets**
  - Equity allocation diversified across US, non-US; developed and emerging markets
  - Core and Core plus fixed income mandates provide some exposure to high yield and non-US fixed income
  - TIPS positioned as economic hedge against future inflation
  - Private equity and real estate provide additional diversification and sources of higher expected return
  
- **NEPC believes that by utilizing additional asset classes, IL SURS can lower its projected risk level in the Policy portfolio while not giving up significant return**
  
- **NEPC recommends that IL SURS consider reducing the equity risk in the overall investment program in favor of the following:**
  - Emerging Markets Debt
  - Hedge equities / Hedge Funds
  - More real asset protection (commodities)

## Recommended 2014 Asset Allocation (Combined Policy Mixes) – March 2014

	Current Allocation	Strategic Policy Target	Mix G (Combination)	Mix H (Combination)
Cash	0%	0%	0%	0%
U.S. Equities	34%	31%	23%	22%
Non U.S. Equities	21%	21%	19%	18%
Global Equity	9%	8%	8%	8%
<b>Total Equity</b>	<b>63%</b>	<b>60%</b>	<b>50%</b>	<b>48%</b>
Core Bonds	19%	19%	19%	19%
EMD Blend	0%	0%	3%	5%
TIPS	4%	4%	4%	4%
<b>Total Fixed Income</b>	<b>23%</b>	<b>23%</b>	<b>26%</b>	<b>28%</b>
Private Equity	7%	6%	6%	6%
Real Estate (Core)	6%	10%	10%	10%
Hedged Equity	0%	0%	5%	5%
Opportunity Fund***	1%	1%	1%	1%
<b>Total Alternatives</b>	<b>14%</b>	<b>17%</b>	<b>22%</b>	<b>22%</b>
Commodities	0%	0%	2%	2%
<b>Total Other</b>	<b>0%</b>	<b>0%</b>	<b>2%</b>	<b>2%</b>
<b>5-7 Yr. Expected Return</b>	<b>6.5%</b>	<b>6.6%</b>	<b>6.5%</b>	<b>6.4%</b>
<b>Standard Dev.</b>	<b>13.1%</b>	<b>12.7%</b>	<b>11.8%</b>	<b>11.6%</b>
<b>30 Yr. Expected Return</b>	<b>7.9%</b>	<b>7.9%</b>	<b>7.7%</b>	<b>7.7%</b>
<b>Sharpe Ratio</b>	<b>0.39</b>	<b>0.40</b>	<b>0.42</b>	<b>0.42</b>

- **A combined allocation of EMD, Hedged Equity, and Commodities results in a well diversified portfolio**
  - While the 5-7 yr. expected return for each portfolio is slightly less than the policy target, the standard deviation of these portfolios are significantly lower
  - By introducing asset classes that are either hedged or relatively uncorrelated to equities, IL SURS will benefit from a higher Sharpe ratio

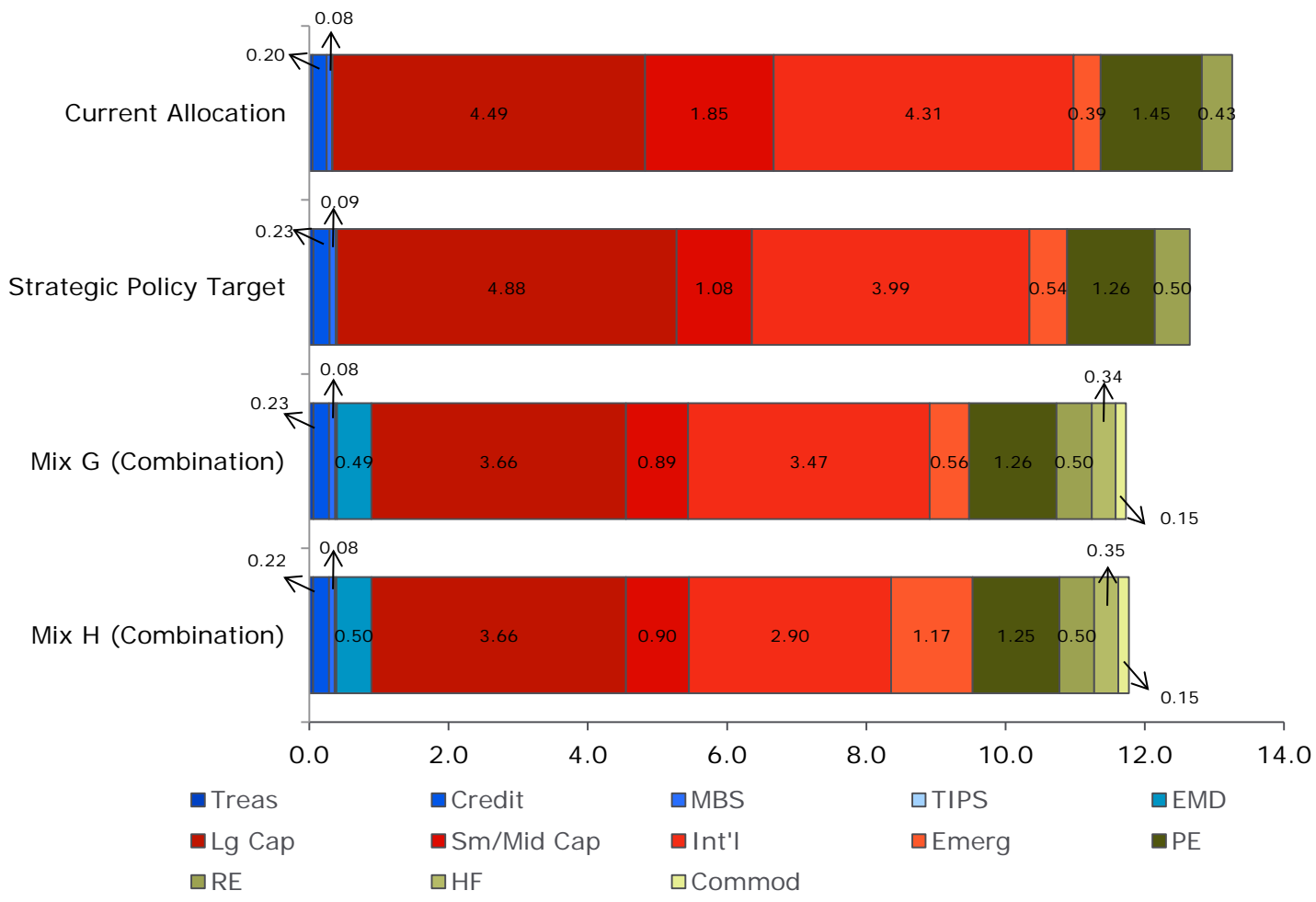
\*The above returns incorporate only the Beta of each asset class and does not incorporate any alpha generated within the portfolio

\*\*The Current Allocation is as of Sept. 30, 2013 and based on the Callan Board Report

\*\*\*The Opportunity fund is modeled as Hedge Fund – Credit (5.0% 5-7 yr. return and 8.0% standard deviation)



# Risk Budgeting examines the sources of portfolio risk



- **NEPC advocated that SURS implement its Hedged Equity allocation by selecting managers in two primary strategy categories**
  
- **Traditional Hedge Fund-of-funds manager strategies**
  - Selection of managers and construction of a diversified portfolio delegated to manager-of-managers (Due to Governance of Plan)
  - Hedge Fund of Funds managers are responsible for negotiating manager contracts, portfolio guidelines, fees and transparency
  - Portfolios will provide broad exposure to between 20 to 45 managers depending on firms selected
  - Target Returns of managers are in the range of LIBOR + 500 basis points
  - Emerging and WMDBE manager programs are available in the marketplace
  - NEPC recommends that SURS target 3% to 4% of its allocation to this category
  
- **Hedged equity strategies including Low Beta, Defensive Equity and Hedge Fund replication**
  - Newer developing category that includes several sub-categories of products that seek to limit, hedge or alternatively manage equity risk (or beta)
  - Strategies use active management and hedging techniques to offer lower risk equity exposure
  - Typically offered at lower fee structures with greater transparency
  - NEPC recommends that SURS target 1% to 2% of its allocation to these strategies

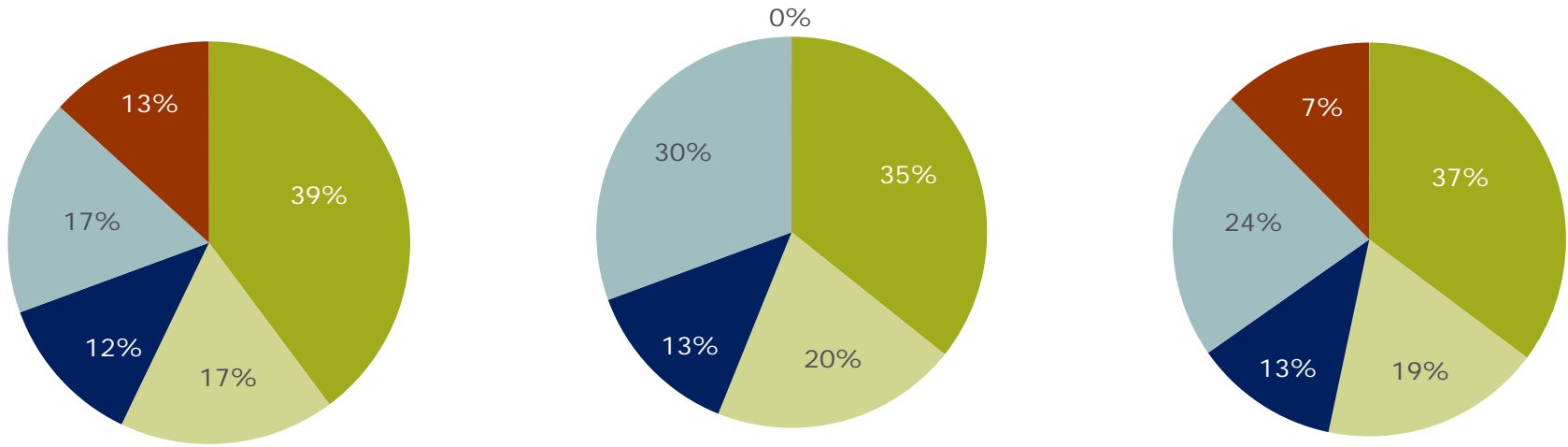
# Portfolio

Current Managers: Strategy Exposures

Prisma Codlin Fund

PAAMCO Newport Monarch

Total Portfolio

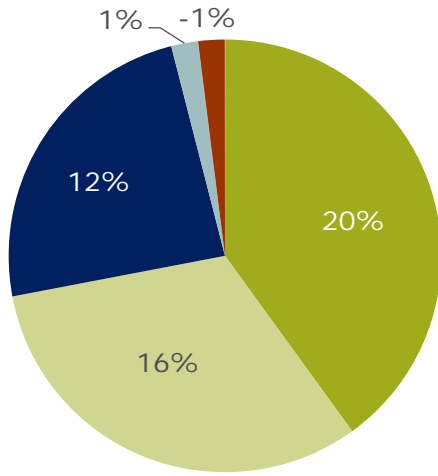


■ Equity-Linked ■ Credit-Linked ■ Event Driven ■ Global Macro ■ Other

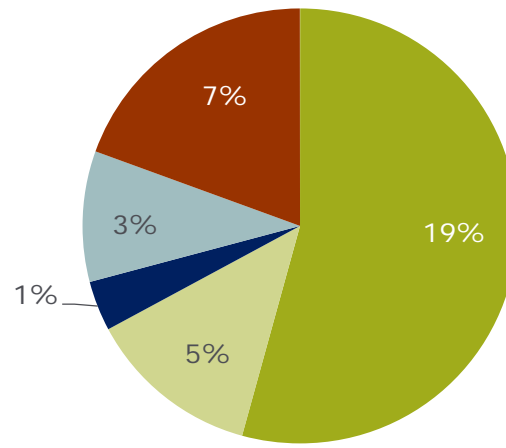
Source: Manager. Strategy weights reflect NEPC buckets for purposes of consistency. Distressed/stressed/restructuring is listed under credit-linked for a more fair representation of manager weighting. NEPC typically categorizes this as event driven otherwise. "Other" reflects Prisma's allocation to niche/tactical. Data is as of September 2017.

Current Managers: Geographic Exposures

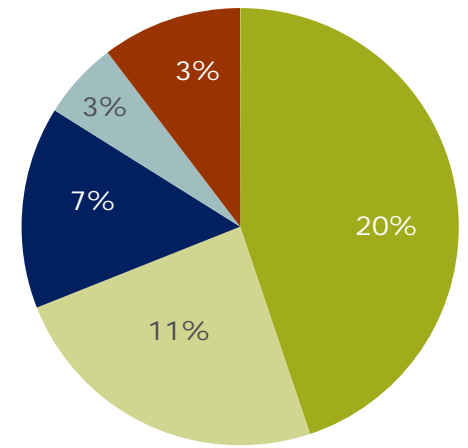
**Prisma Codlin**



**PAAMCO Newport Monarch**



**Total Portfolio**



■ North America ■ Europe ■ Asia ■ Latin America ■ Other

Source: Manager. Net exposures shown as of September 2017

## Current Managers: Performance

Fund	Returns		
	YTD	1 Year	Since Inception
Prisma Codlin	5.3%	6.0%	4.3%
PAAMCO Newport Monarch	5.5%	6.7%	6.1%
Total Portfolio	5.4%	6.3%	5.0%
HFRI FOF Composite	5.6%	6.5%	6.3%
S&P 500	14.2%	18.6%	16.8%
Barclays Aggregate	3.1%	0.1%	1.8%
LIBOR +5	4.7%	6.2%	6.1%

Source: NEPC/eVestment. Common start date April 2016 for consistency of returns due to different fund inception dates. YTD returns as of September 2017

# NEPC Views of Hedge Fund Industry

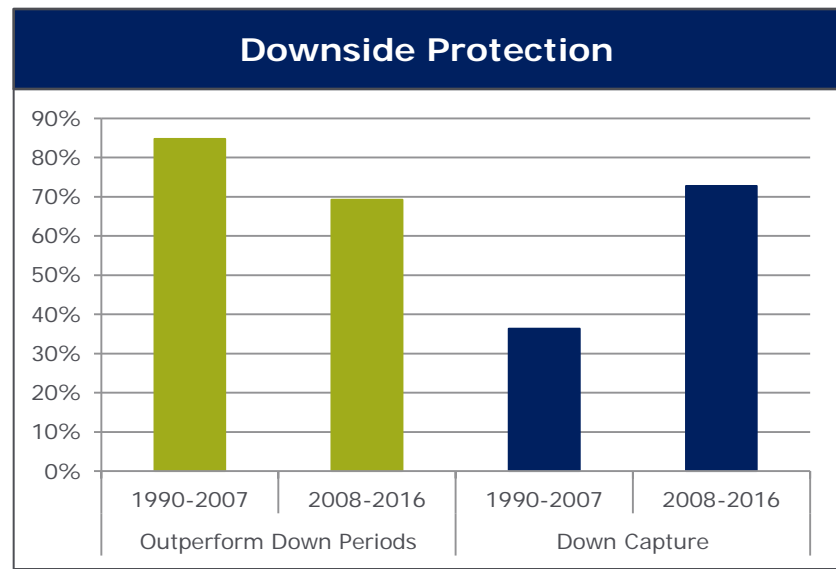
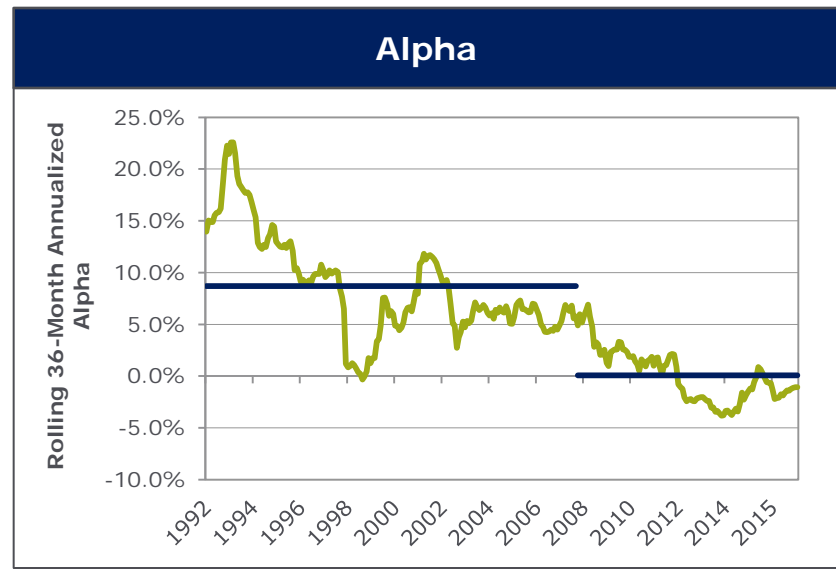
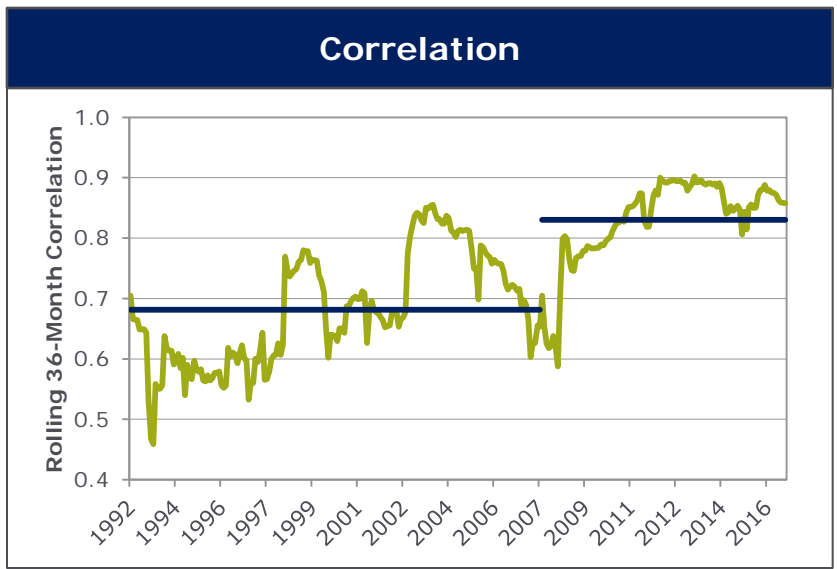
# Why invest in hedge funds? A historical perspective



## Why invest in hedge funds?

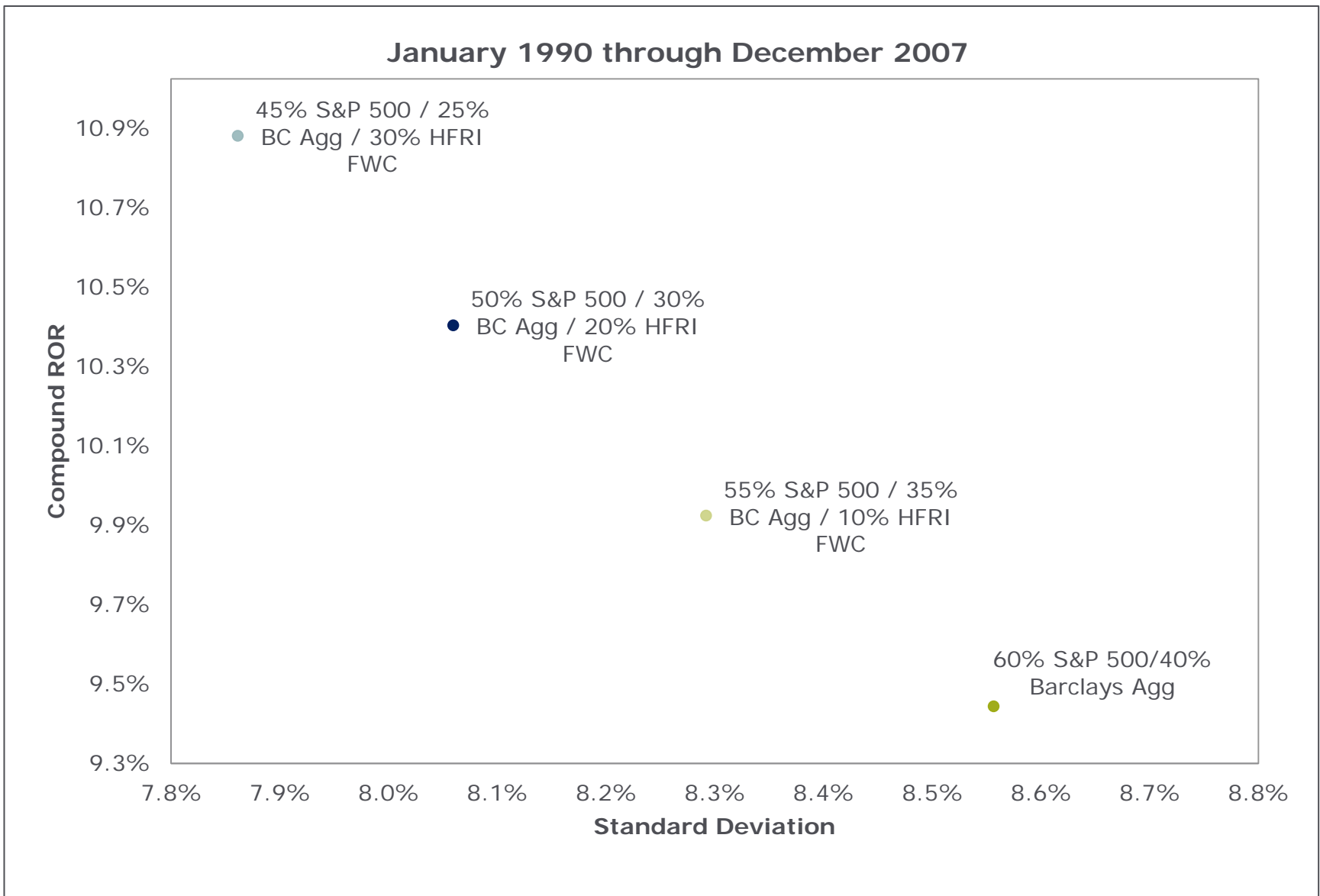
- **Potentially higher returns and alpha**
- **Diversification**
- **Access to non-traditional strategies**

# Value Proposition of Hedge Funds



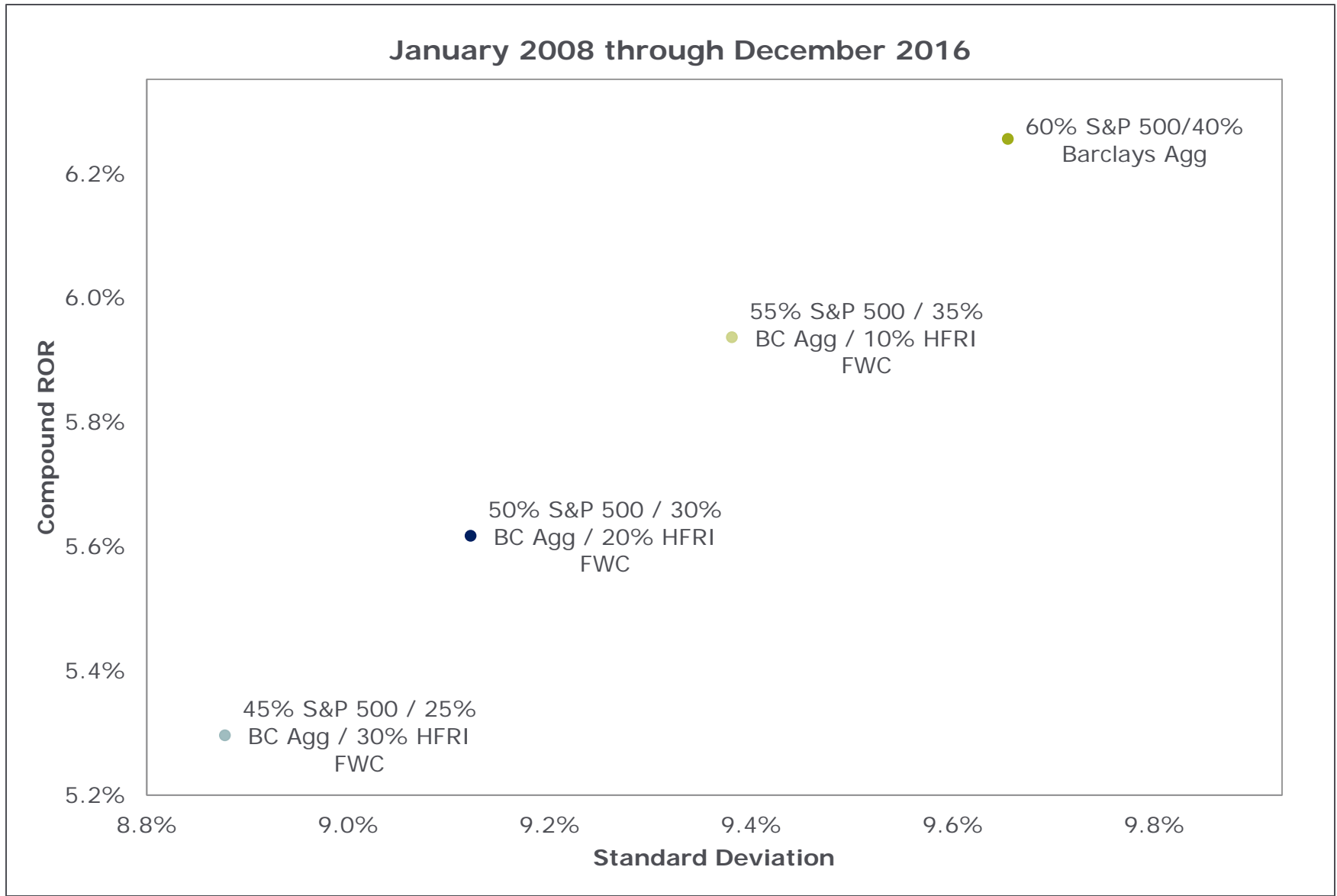
Source: eVestment, HFR; statistics compare HFRI Fund Weighted Composite versus 60% S&P 500/40% Barclays Agg Portfolio from Jan 1990 through December 2007 as well as over Jan 2008 through Dec 2016

Historical Portfolio Impact

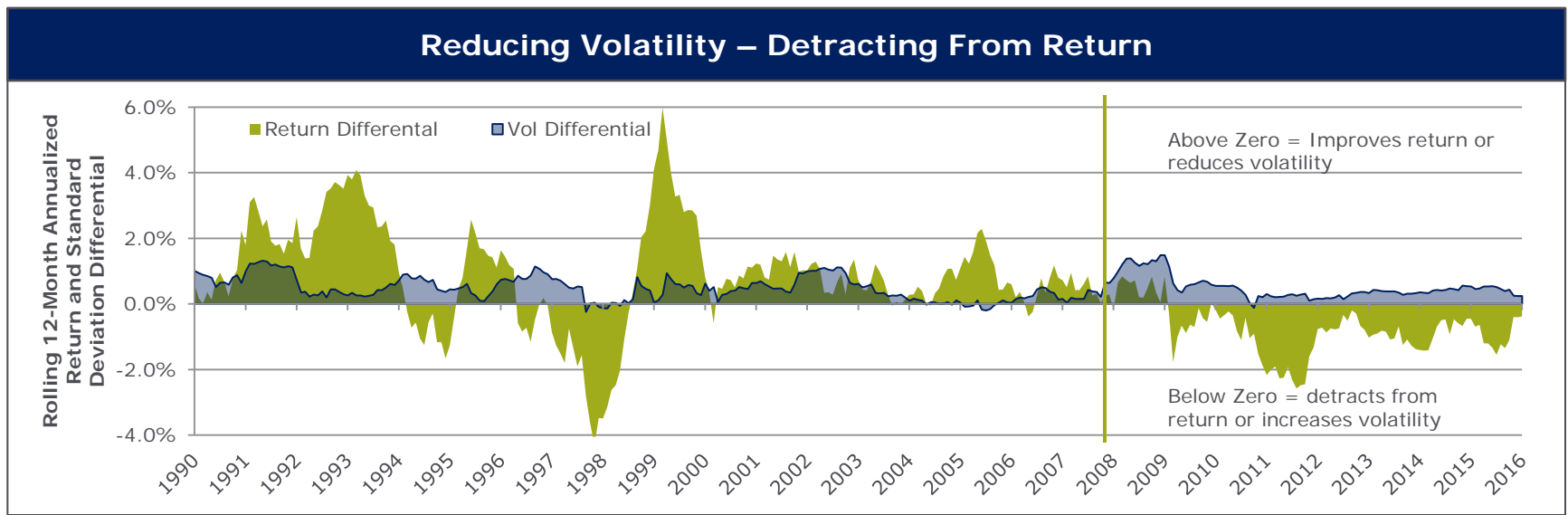
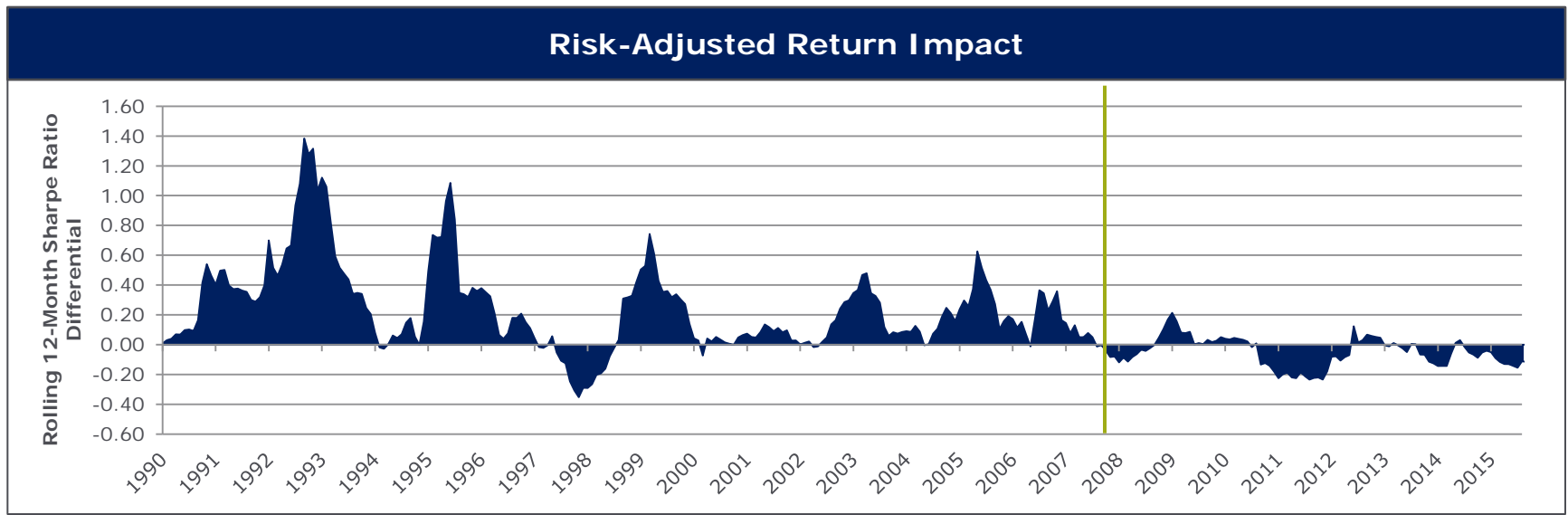


Source: eVestment, HFR; Pro-forma performance statistics calculated from Jan 1990 through Dec 2007

Post-Crisis Results – Not Meeting Expectations



Source: eVestment, HFR; pro-forma performance statistics calculated from Jan 2008 through Dec 2016



Source: eVestment, HFR; Statistics based on pro-forma 60% S&P 500/40% Barclays Agg portfolio versus 50% S&P 500/30% Barclays Agg/20% HFRI FWC

# What Changed?

## Potential Drivers for Change in Hedge Fund Performance

- **Global monetary policy impacts**
- **Regulatory changes**
- **Industry growth**

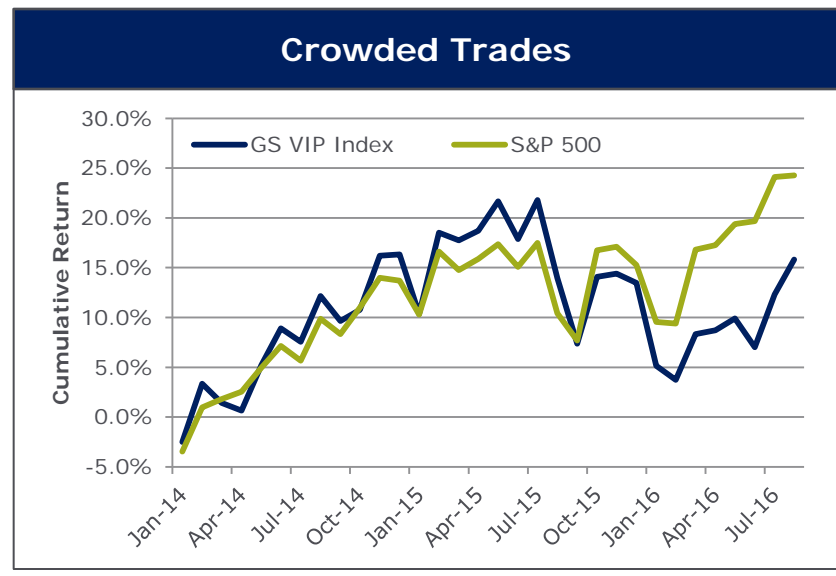
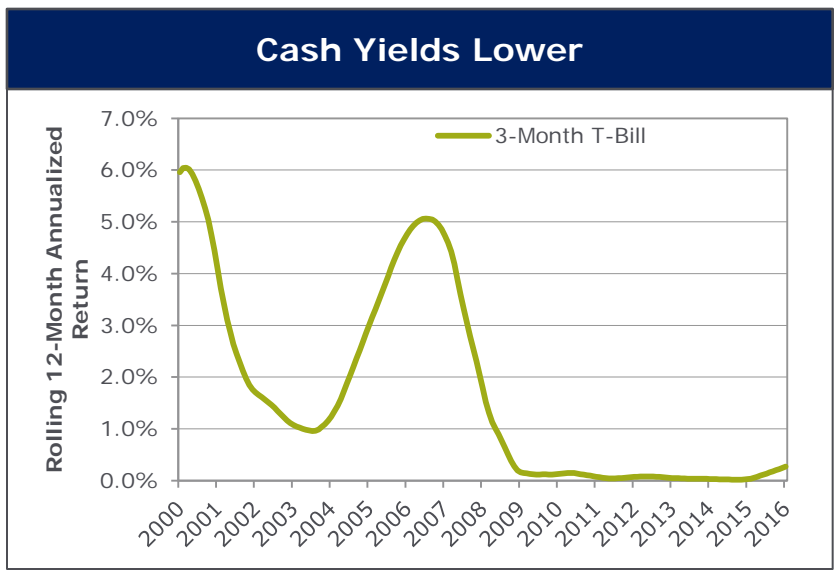
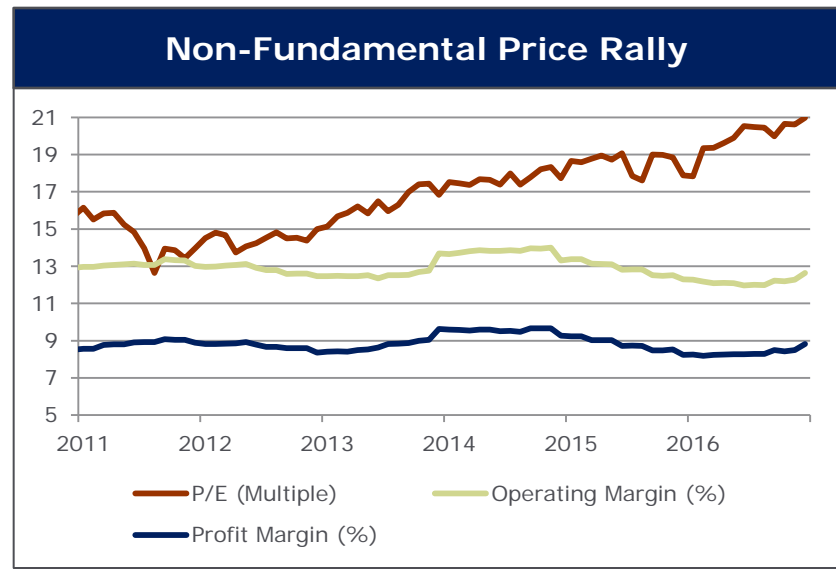
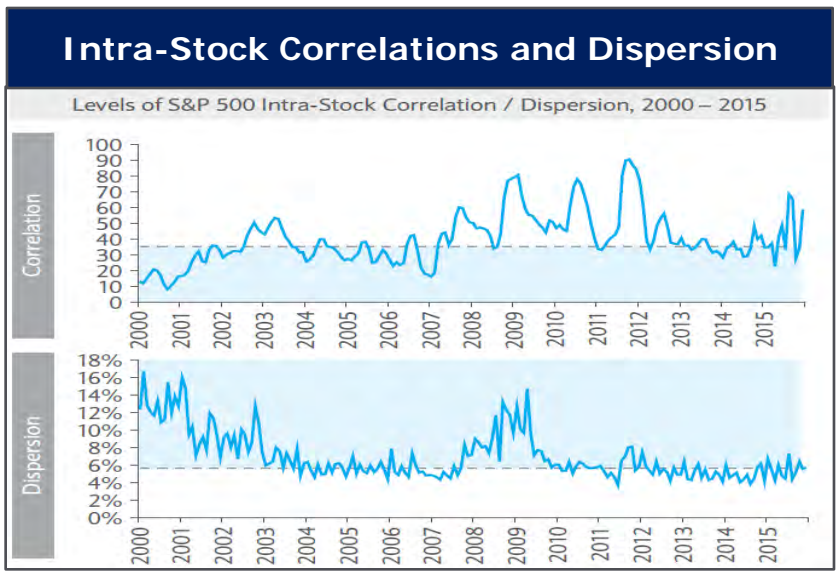
# Extraordinary Global Monetary Policy



Source: eVestment, HFR



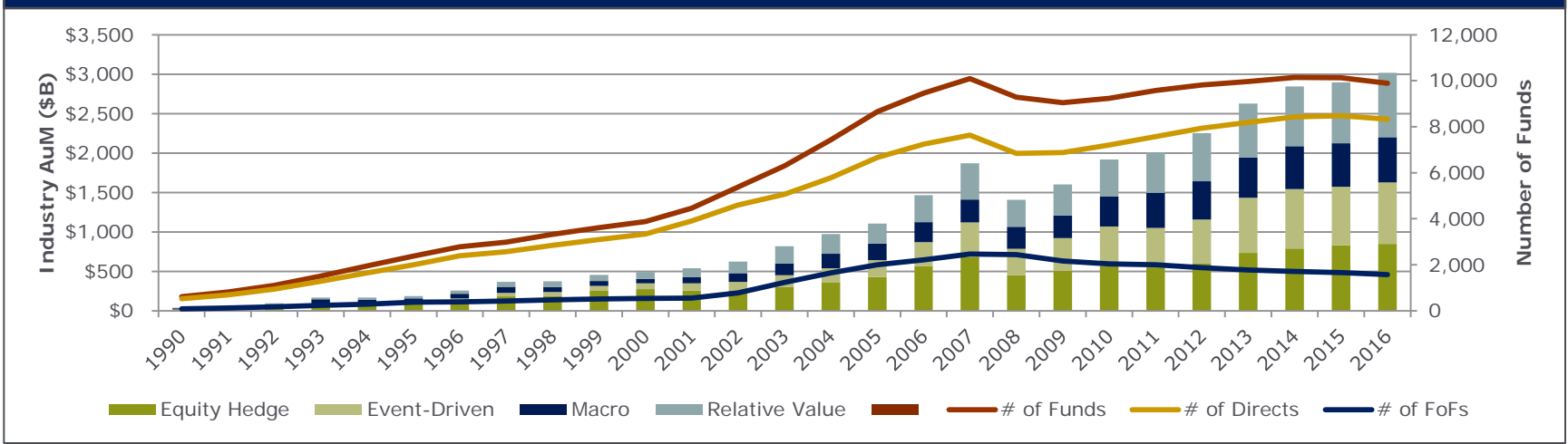
# Did the playing field change?



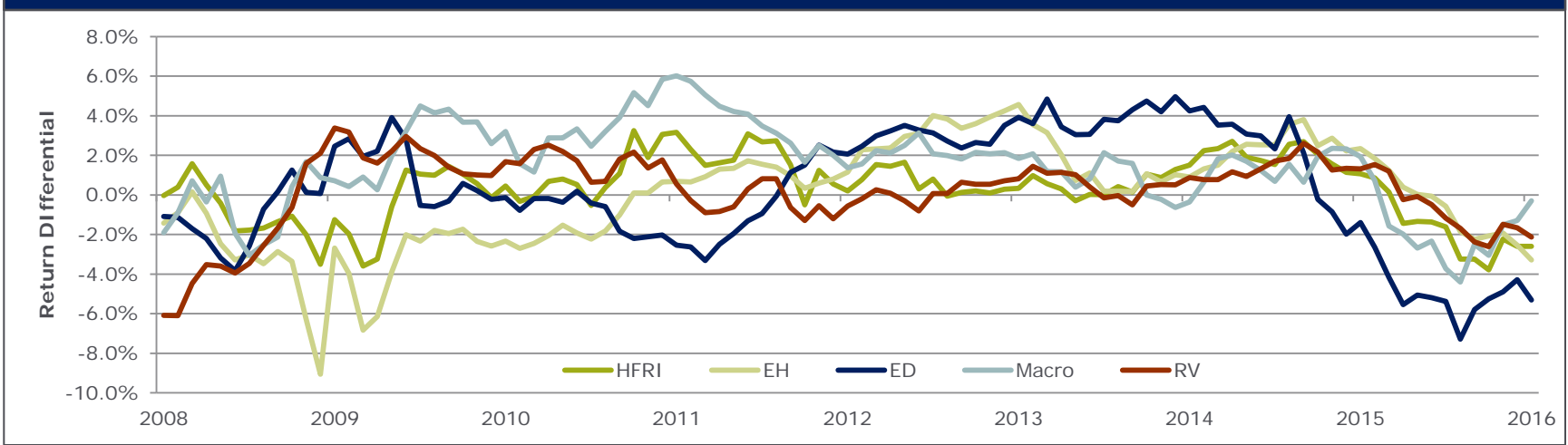
Source: Barclays, Bloomberg, eVestment, Goldman Sachs

# Industry Growth

## Growth by Strategy

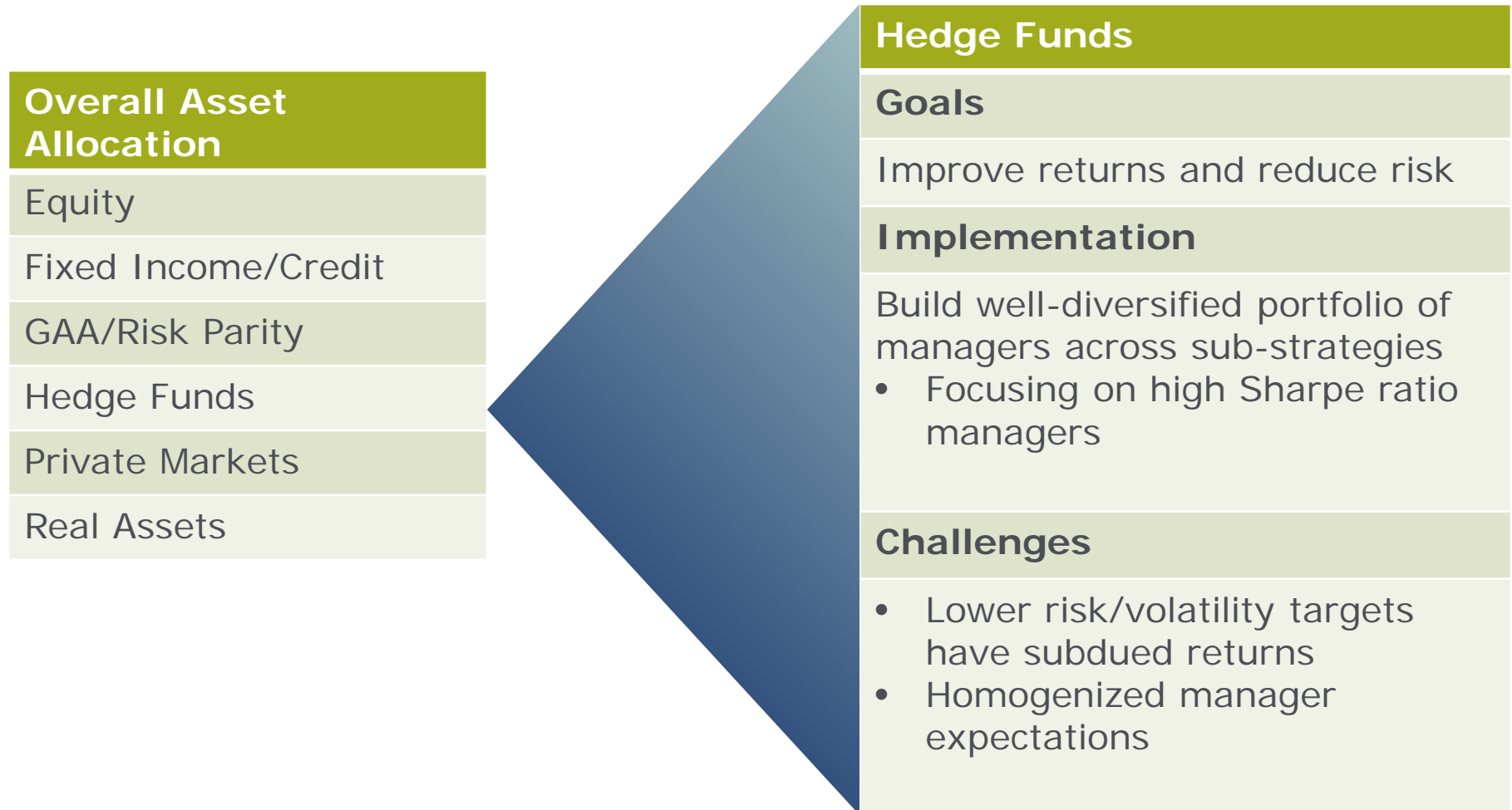


## Larger Funds Underperforming Recently



Sources: HFR, eVestment, Barclays; lower chart represents return differential of asset-weighted index versus equal-weighted index

# Hedge Funds Going Forward



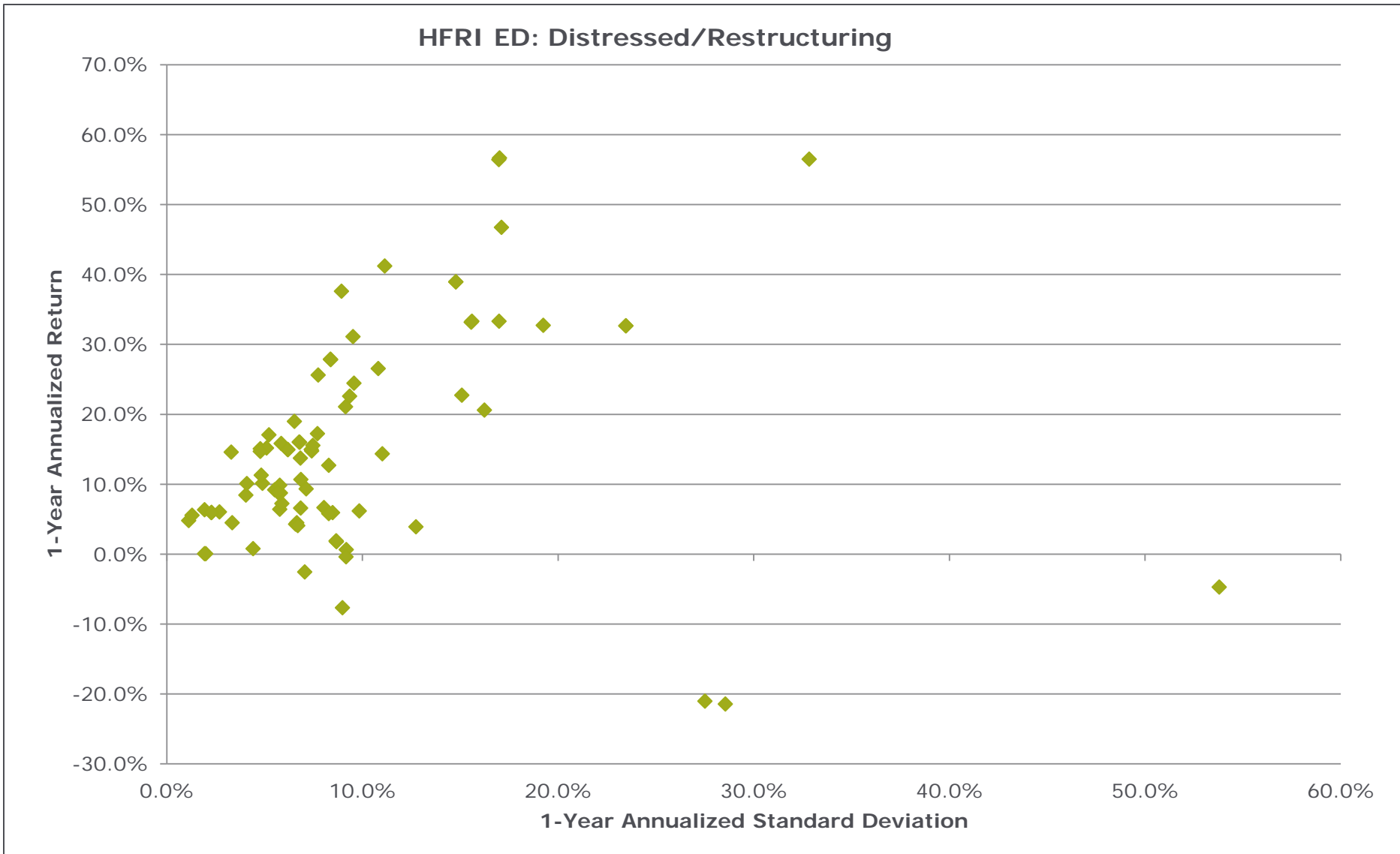
**Hedge funds are not an asset class.**

# Sub-Strategy Dispersion

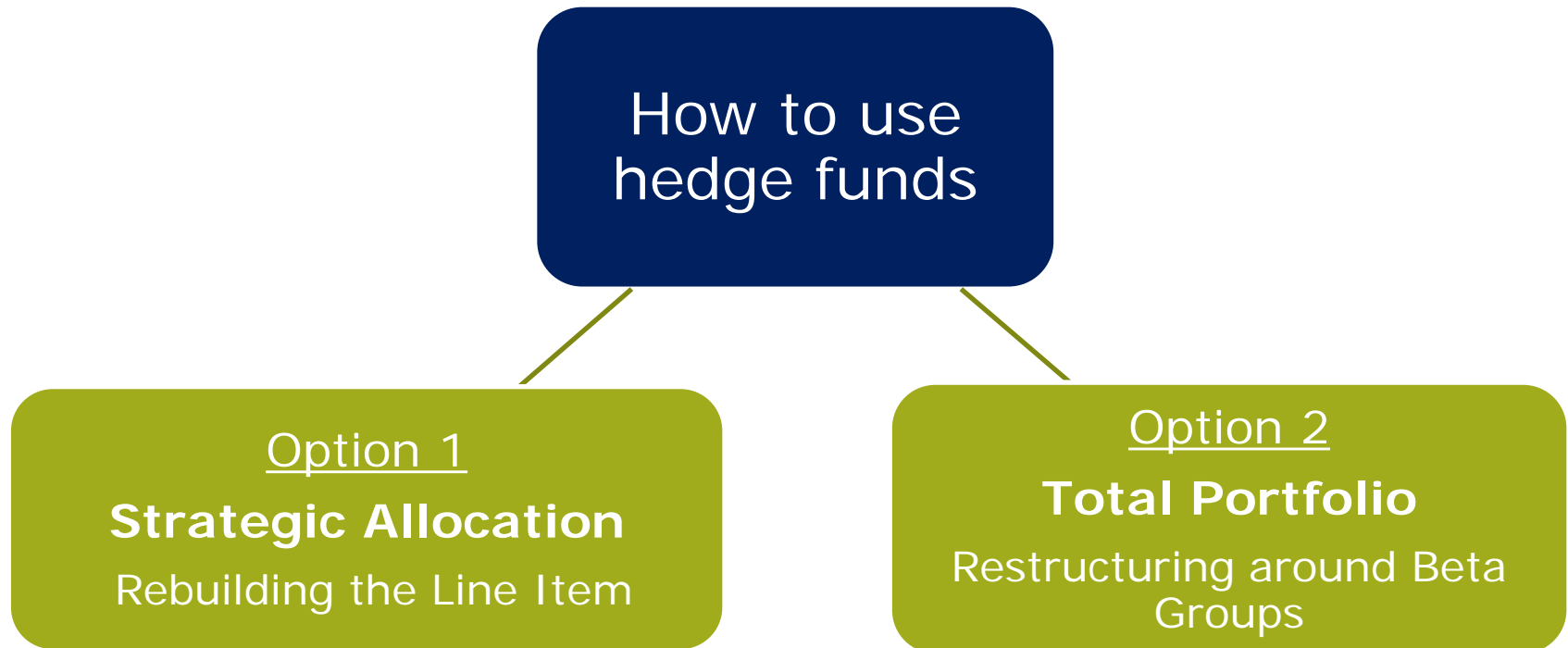
2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Barclays Gov't/Credit 12.10%	HFRI Emerging Markets 39.36%	HFRI ED: Distressed 18.89%	HFRI Emerging Markets 21.04%	HFRI Emerging Markets 24.26%	HFRI Emerging Markets 24.92%	Barclays Gov't/Credit 6.09%	HFRI RV: ConvertArb 60.17%	S&P 500 15.08%	Barclays Gov't/Credit 9.24%	S&P 500 15.99%	S&P 500 32.36%	S&P 500 13.65%	HFRI EH: Eq Mrkt Ntrl 4.27%	HFRI ED: Distressed 14.34%
HFRI RV: ConvertArb 9.05%	HFRI ED: Distressed 29.56%	HFRI Emerging Markets 18.42%	HFRI Equity Hedge 10.60%	HFRI ED: Distressed 15.94%	HFRI Macro 11.11%	HFRI Macro 4.83%	HFRI Emerging Markets 40.25%	HFRI RV: ConvertArb 13.35%	S&P 500 2.09%	HFRI Relative Value 10.59%	HFRI Equity Hedge 14.28%	Barclays Gov't/Credit 6.32%	HFRI ED: Merger Arb 3.32%	S&P 500 11.93%
HFRI Macro 7.44%	S&P 500 28.67%	HFRI Event-Driven 15.01%	HFRI Fund Wghtd Comp 9.30%	S&P 500 15.78%	HFRI Equity Hedge 10.48%	HFRI ED: Merger Arb -5.37%	HFRI ED: Distressed 28.14%	HFRI ED: Distressed 12.12%	HFRI ED: Merger Arb 1.50%	HFRI Emerging Markets 10.37%	HFRI ED: Distressed 14.05%	HFRI Macro 5.58%	HFRI RV: ConvertArb 1.92%	HFRI Event-Driven 10.50%
HFRI Relative Value 5.44%	HFRI Event-Driven 25.33%	S&P 500 10.86%	HFRI ED: Distressed 8.27%	HFRI Event-Driven 15.33%	HFRI FOF Composite 10.25%	HFRI EH: Eq Mrkt Ntrl -5.92%	S&P 500 26.47%	HFRI Event-Driven 11.86%	HFRI Relative Value 0.15%	HFRI ED: Distressed 10.12%	HFRI Event-Driven 12.51%	HFRI Relative Value 4.02%	S&P 500 1.38%	HFRI RV: ConvertArb 7.86%
HFRI ED: Distressed 5.28%	HFRI Macro 21.42%	HFRI Fund Wghtd Comp 9.03%	HFRI FOF Composite 7.49%	HFRI ED: Merger Arb 14.24%	HFRI Fund Wghtd Comp 9.96%	HFRI Relative Value -18.04%	HFRI Relative Value 25.81%	HFRI Emerging Markets 11.44%	HFRI ED: Distressed -1.79%	HFRI Event-Driven 8.89%	HFRI Fund Wghtd Comp 9.13%	HFRI FOF Composite 3.37%	Barclays Gov't/Credit 0.15%	HFRI Relative Value 7.77%
HFRI Emerging Markets 3.70%	HFRI Equity Hedge 20.54%	HFRI Equity Hedge 7.68%	HFRI Event-Driven 7.29%	HFRI Fund Wghtd Comp 12.89%	HFRI Relative Value 8.94%	HFRI Fund Wghtd Comp -19.03%	HFRI Event-Driven 25.04%	HFRI Relative Value 11.43%	HFRI EH: Eq Mrkt Ntrl -2.13%	HFRI RV: ConvertArb 8.58%	HFRI FOF Composite 8.96%	HFRI EH: Eq Mrkt Ntrl 3.06%	HFRI FOF Composite -0.27%	HFRI Emerging Markets 6.77%
HFRI FOF Composite 1.02%	HFRI Fund Wghtd Comp 19.55%	HFRI FOF Composite 6.86%	HFRI Macro 6.79%	HFRI Relative Value 12.37%	Barclays Gov't/Credit 7.75%	HFRI FOF Composite -21.37%	HFRI Equity Hedge 24.57%	HFRI Equity Hedge 10.45%	HFRI Event-Driven -3.30%	HFRI Equity Hedge 7.41%	HFRI RV: ConvertArb 8.02%	HFRI Fund Wghtd Comp 2.98%	HFRI Relative Value -0.29%	HFRI Fund Wghtd Comp 5.51%
HFRI EH: Eq Mrkt Ntrl 0.98%	HFRI FOF Composite 11.61%	HFRI Relative Value 5.58%	HFRI ED: Merger Arb 6.25%	HFRI RV: ConvertArb 12.17%	HFRI ED: Merger Arb 7.05%	HFRI Event-Driven -21.82%	HFRI Fund Wghtd Comp 19.98%	HFRI Fund Wghtd Comp 10.25%	HFRI Macro -4.16%	HFRI Fund Wghtd Comp 6.36%	HFRI Relative Value 7.07%	HFRI Equity Hedge 1.81%	HFRI Equity Hedge -0.97%	HFRI Equity Hedge 5.49%
HFRI ED: Merger Arb -0.87%	HFRI RV: ConvertArb 9.93%	HFRI Macro 4.63%	HFRI EH: Eq Mrkt Ntrl 6.22%	HFRI Equity Hedge 11.71%	HFRI Event-Driven 6.61%	HFRI ED: Distressed -25.20%	HFRI ED: Merger Arb 11.65%	HFRI Macro 8.06%	HFRI RV: ConvertArb -5.16%	Barclays Gov't/Credit 5.07%	HFRI EH: Eq Mrkt Ntrl 6.46%	HFRI ED: Merger Arb 1.69%	HFRI Fund Wghtd Comp -1.12%	HFRI ED: Merger Arb 3.73%
HFRI Fund Wghtd Comp -1.45%	HFRI Relative Value 9.72%	Barclays Gov't/Credit 4.54%	HFRI Relative Value 6.02%	HFRI FOF Composite 10.39%	S&P 500 5.49%	HFRI Equity Hedge -26.65%	HFRI FOF Composite 11.47%	Barclays Gov't/Credit 6.99%	HFRI Fund Wghtd Comp -5.25%	HFRI FOF Composite 4.79%	HFRI Emerging Markets 5.47%	HFRI RV: ConvertArb 1.55%	HFRI Macro -1.26%	Barclays Gov't/Credit 3.19%
HFRI Event-Driven -4.30%	HFRI ED: Merger Arb 7.47%	HFRI EH: Eq Mrkt Ntrl 4.15%	S&P 500 4.91%	HFRI Macro 8.15%	HFRI RV: ConvertArb 5.33%	HFRI RV: ConvertArb -33.73%	Barclays Gov't/Credit 4.81%	HFRI FOF Composite 5.70%	HFRI FOF Composite -5.72%	HFRI EH: Eq Mrkt Ntrl 2.98%	HFRI ED: Merger Arb 4.74%	HFRI Event-Driven 1.08%	HFRI Emerging Markets -3.28%	HFRI EH: Eq Mrkt Ntrl 1.80%
HFRI Equity Hedge -4.71%	Barclays Gov't/Credit 5.07%	HFRI ED: Merger Arb 4.08%	Barclays Gov't/Credit 2.55%	HFRI EH: Eq Mrkt Ntrl 7.32%	HFRI EH: Eq Mrkt Ntrl 5.29%	S&P 500 -36.99%	HFRI Macro 4.34%	HFRI ED: Merger Arb 4.60%	HFRI Equity Hedge -8.38%	HFRI ED: Merger Arb 2.76%	HFRI Macro -0.44%	HFRI ED: Distressed -1.39%	HFRI Event-Driven -3.55%	HFRI Macro 1.29%
S&P 500 -22.09%	HFRI EH: Eq Mrkt Ntrl 2.44%	HFRI RV: ConvertArb 1.18%	HFRI RV: ConvertArb -1.86%	Barclays Gov't/Credit 4.07%	HFRI ED: Distressed 5.08%	HFRI Emerging Markets -37.26%	HFRI EH: Eq Mrkt Ntrl 1.43%	HFRI EH: Eq Mrkt Ntrl 2.85%	HFRI Emerging Markets -14.01%	HFRI Macro -0.06%	Barclays Gov't/Credit -2.47%	HFRI Emerging Markets -2.56%	HFRI ED: Distressed -8.06%	HFRI FOF Composite 0.71%

Sources: HFR; Past performance is no guarantee of future results.

Individual Manager Dispersion



Sources: HFR – constituents of HFRI ED: Distressed/Restructuring Index; performance as of 12/31/2016  
 Past performance is no guarantee of future results.





## Option 1) Maintaining Strategic Allocation - Rebuilding the Line Item



## Return Enhancement

### Goal

Boost portfolio returns

### Implementation

Focus on strategies exhibiting:

- Strong absolute returns
- Higher volatility
- Consistent alpha

### Challenges

- May exhibit higher correlation/Beta to markets
- May experience higher volatility and drawdowns

## Diversification

### Goal

Improve overall portfolio risk-adjusted return

### Implementation

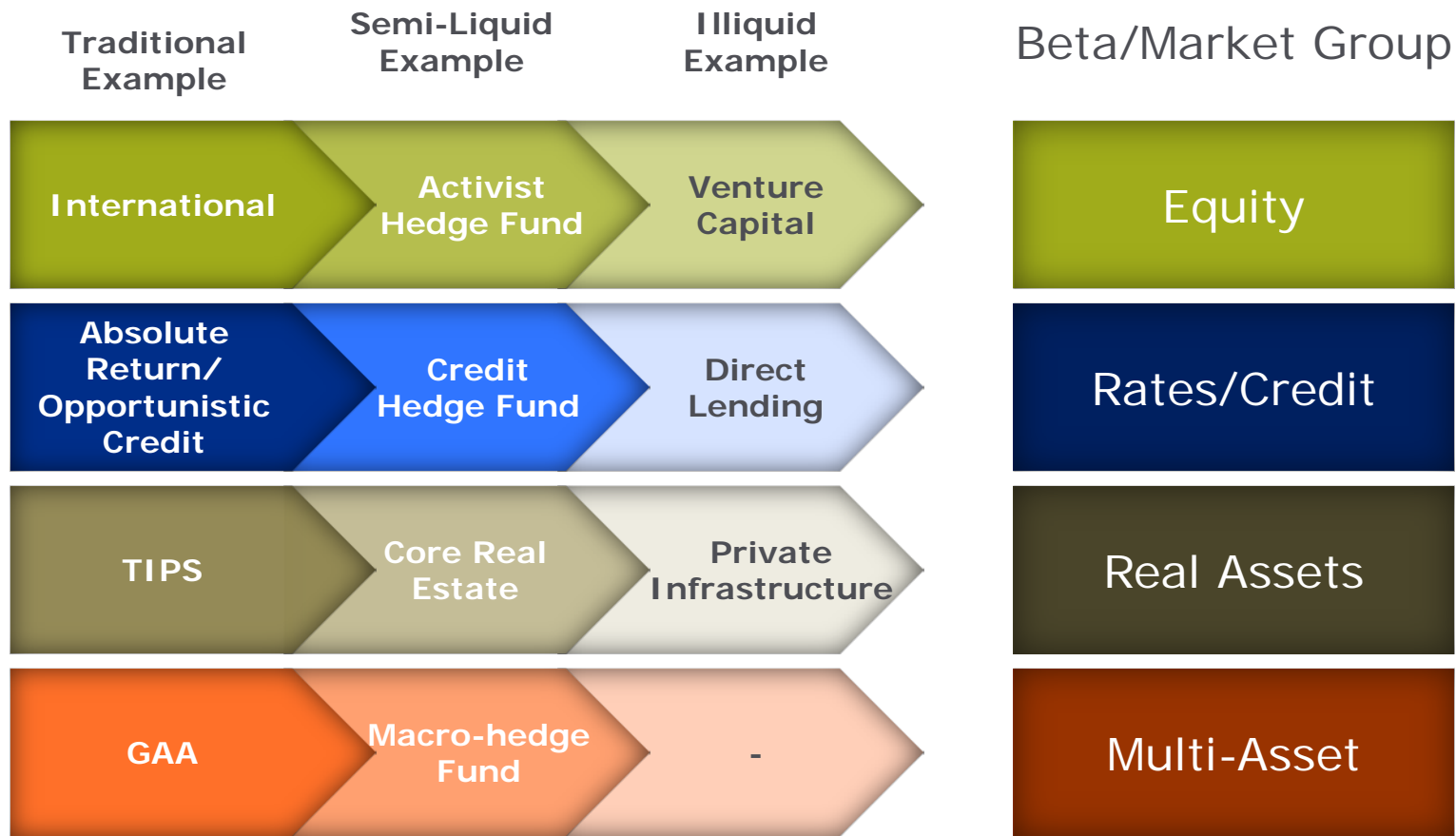
Focus on strategies exhibiting:

- Low/moderate correlation
- Low/moderate volatility
- Strong Sharpe ratio
- Limited historical drawdown

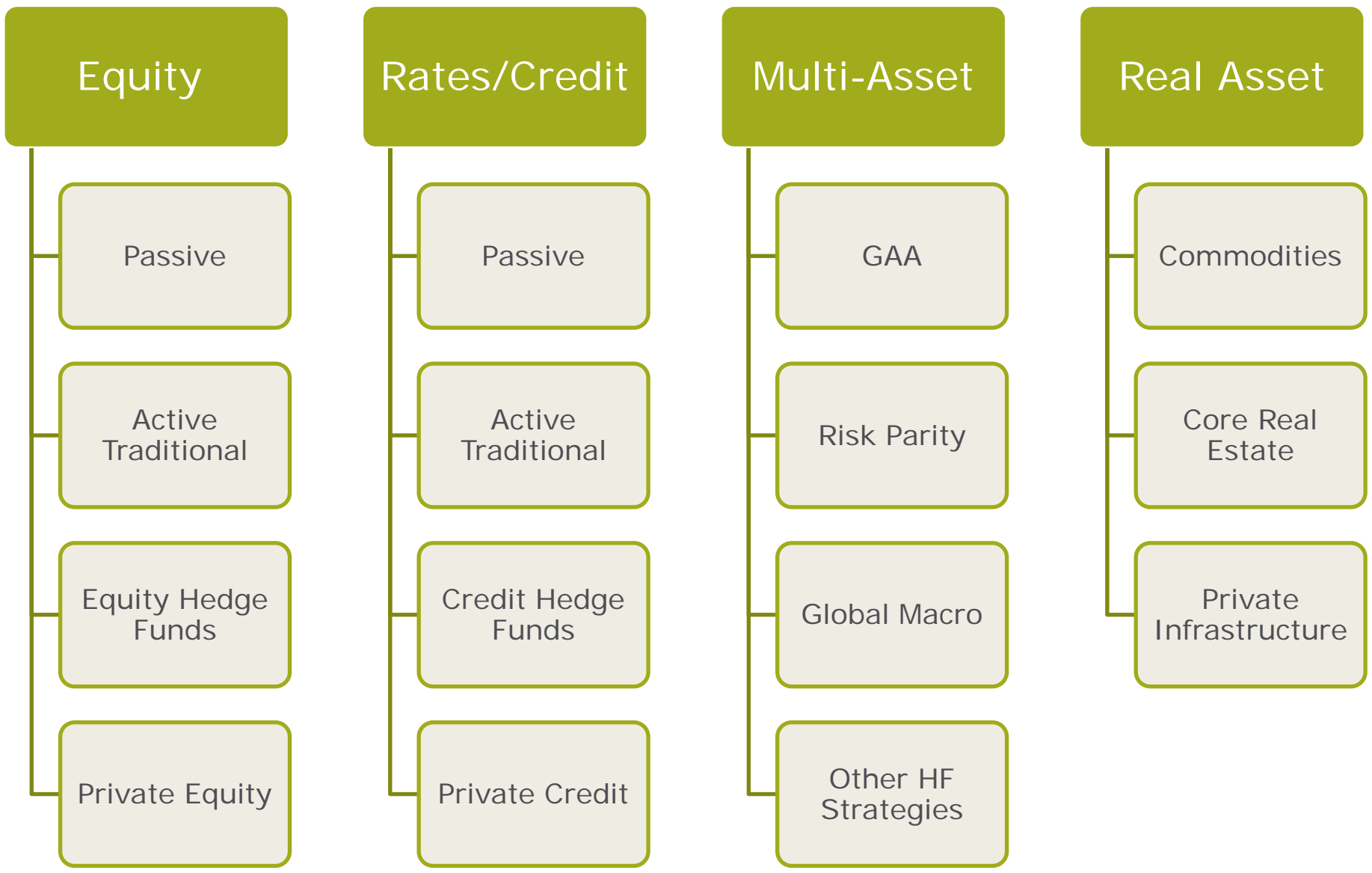
### Challenges

- May exhibit low absolute returns

**Combining vertical expertise in asset classes with dynamic markets views to provide optimal implementation for each client**



# Option 2) Disaggregating – Reconstructing Around Beta Groups



## Option 2) Disaggregating – Reconstructing Around Beta Groups

Benefits	Challenges
Holistic Opportunistic Manager Assessment	Reporting/Benchmarking Peer Risk Opportunity Cost

- **What do I want hedge funds to do for me?**
- **How can I maximize value for cost across my portfolio?**

# Conclusion

- **Differences between NEPC views and Plan Portfolio**
  - FOFs vs Directs (additional layer of fees)
  - Funded Status of Plan vs Ability to take on additional volatility/drawdown risk if desire to pursue higher returns

# Appendix: Disclaimers and Disclosures



**It is important that investors understand the following characteristics of non-traditional investment strategies including hedge funds and private equity:**

1. Performance can be volatile and investors could lose all or a substantial portion of their investment
2. Leverage and other speculative practices may increase the risk of loss
3. Past performance may be revised due to the revaluation of investments
4. These investments can be illiquid, and investors may be subject to lock-ups or lengthy redemption terms
5. A secondary market may not be available for all funds, and any sales that occur may take place at a discount to value
6. These funds are not subject to the same regulatory requirements as registered investment vehicles
7. Managers may not be required to provide periodic pricing or valuation information to investors
8. These funds may have complex tax structures and delays in distributing important tax information
9. These funds often charge high fees
10. Investment agreements often give the manager authority to trade in securities, markets or currencies that are not within the manager's realm of expertise or contemplated investment strategy